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3 Money Rules That No Longer Apply

By Akweli Parker, **December 2008**

When it comes to money, it comforts us to think that inviolable—even timeless—rules govern the making of wealth and the keeping of it. After all, we're a society built on rules—so why should investing be any different?

But this year's economic maelstrom continues to wreck the portfolios and net worth's of millions of people—many of whom dutifully "followed the rules." Clearly, something is very wrong when your faithfully funded 401(k) loses more than one-third of its value (meanwhile, there's talk of "reduced" bonuses for many of the fallen kings of Wall Street. Bonuses?!?).

We can't help you get mob justice. But we did go to the experts for some help on how you might lessen or avoid the same fate as the trusting masses—because, as we've witnessed, following the common wisdom can be like following your fellow buffaloes over the cliff. Instead, here are Three Money Rules That No Longer Apply—and how you should proceed.

Max Out The 401(k)
Like mom, financial gurus have lovingly nagged us to shovel as much tax-free money as possible into 401(k) retirement plans. Certainly for the compounded growth, and just as importantly, to stick it to the tax man.

But Rita Cheng, a Bethesda, Maryland, financial planner with Ameriprise Financial Services, says that generic advice for the masses may be wrong for you.

"Just as we tell investors to have investment diversification, it is important to have tax diversification. There is so much that the market meltdown has taught," Cheng says.

"We cannot control market conditions or tax rates, so a proactive and diversified tax and investment strategy may make sense."

How does one achieve tax diversification? Start by dividing your retirement accounts between a traditional 401(k) and a Roth account. With a regular 401(k), everything you sock away is tax-deferred—Uncle Sam doesn't reach in until you make a withdrawal from the account.

With a Roth IRA or a Roth 401(k), you invest with after-tax dollars and your returns accumulate tax-free; there's no tax on withdrawals made in retirement, provided you're above age 59 ½ and have held the account at least five years.

If you expect to be in a higher tax bracket—or if you think the overall tax structure will be more onerous—when you retire than now, a Roth might be the right move. If you guess right, you will effectively pay less in taxes by paying up-front.

At the very least, a mixed approach allows you to hedge the tax risks.

You have no power over what happens to the markets, Cheng says. But you can make an informed decision on how to fork over less to the IRS. In short, control what you can control.

Diversify for Safety
Investment gurus have fought like the Hatfields and McCoys over this one for decades. Is it better to invest in a broad array of assets—stocks, bonds, real estate, and other asset classes? Mutual funds and index funds are, after all, diversity plays.

Or is it wiser to do as Andrew Carnegie advised: Put all your eggs in one basket ... and then closely watch that basket? Recent events, at least, have been a blow against diversification.

"In our current market, all asset classes fell—all," says Michael Phillips Black, a certified financial planner in Scottsdale, Arizona. "Therefore, classic diversification does not work [in the current market]. Until rational movements to the markets are restored, trying to re-balance now won't work."

So will it ever make sense to "re-balance" toward a particular type of asset, like stocks? Eventually yes, says Black. "But there is no 'safe' allocation now."

"The rescue plan will take time to take effect, if there is an effect," Black says. "So, we are not making any particular strategic decisions now, other than hold tight until we see a defined trend change.

"Once this market has bottomed out and starts moving upward, we all need to take a deep breath and look at the world from a fresh starting point to determine where to go from there."

Subtract Your Age From 100
Think of this venerable rule as the blunt instrument of financial advice—subtract your age from 100 and use the answer as the percentage of your total investments held in stocks. And if you used it this year, then you know firsthand the meaning of "blunt force trauma."

Tom Adams, a CPA with Mentor Capital Management in Elmhurst, Illinois, calls it, "especially not useful nowadays."

"This rule isn't a wise one to use because everyone's risk tolerance is different, no matter what their age is, and the recent stock market meltdown has shown many people that they have less risk tolerance than they thought," Adams says.

Is it time to bring back the mattress or the backyard coffee can as the preferred safe haven for cash? No, but the ridicule reserved for keeping significant amounts of low-yielding cash deserves new scrutiny.

"We tell our clients, 'You need to save money, keep it saved, then invest it at the right time, in the right place,' " says Rafael O. Velez III, managing director for Summit Financial Advisors in San Mateo, California.

"Having cash in your portfolio provides significant advantages for investors," Velez says. Not the least of which is flexibility—for both emergencies and real opportunities—and the ability "to be greedy when others are fearful." Attentive readers might recognize that phrase as one that was recently penned by Warren Buffett.